Quarterly Commentary: Q1 2020

VALLEY NATIONAL
FINANCIAL ADVISORS

Equities:

We cautioned in our Q4 commentary that equity market returns last year were achieved on the back of stagnant earnings growth, and that "a tempering of return expectations" may be warranted moving into 2020. Of course, nobody could have predicted that just weeks later, the world would be in the midst of a global pandemic and that financial markets would have been thrown into a state of complete disarray. The rapidity with which markets retreated from their highs in response to the global spread of COVID-19 was historic, and largely representative of the massive shock that the disease poses to the global economy. Stocks across virtually every sector lost significant value, and there was largely nowhere for investors to hide. Volatility in the US equity market (as measured by the VIX) reached its highest level in history, surpassing the previous record set in November of 2008. Over the long-term, equity market returns are driven by fundamentals, but the term "fundamentals" was completely tossed aside during the first quarter as the extraordinary level of uncertainty opened the doors for panic to become the main determinant of market prices. Unfortunately, until the world is able to emerge on the other side of "the curve", a clearer understanding of market fundamentals will not be achievable, and volatility will continue to be the norm. However, it is vital that investors continue to remind themselves that the economic impacts of COVID-19 will be transitory.

Bonds:

What made the first quarter exponentially more painful for investors was that bonds (traditionally viewed as much safer than equities) were not spared from the selloff. In fact, it could be argued that when compared to historical norms, the volatility seen in the bond market was even worse. As fear and panic took hold, buyers disappeared from bond markets just as they did in equity markets, leading to a complete evaporation of liquidity and significant markdowns in bond prices. The Federal Reserve responded swiftly by committing a significant amount of capital as a buyer of last resort, and this helped to stabilize pricing toward the end of the quarter, but much of the damage was already done. Moving forward, default rates on lower quality bonds are likely to accelerate meaningfully. However, because the massive selloff occurred across bonds of all credit quality, many investors in higher quality bonds will likely recoup their losses as their bonds eventually mature and return principal.

Outlook:

It goes without saying that the equity bull market finally came to an end in the first quarter, and it is likely safe to say that the second quarter of 2020 will represent the beginning of the next economic cycle. The transition from one cycle to another is always a challenging time, but we believe there are a couple of key factors that should help to keep investor fears at bay. First, both the Federal Reserve and the US Government are responding to the crisis with full force. We have no way of knowing when life will begin returning to normal and when we will be able to shift our focus to revitalizing the economy. But when that day arrives, the impact of such massive economic policy initiatives should not be discounted. The second factor that should help to preserve some level of optimism is the health of the US financial system. Many investors are still scarred by the 2008 financial crisis, but while the banking system became the epicenter of the carnage in 2008, it is likely to be an essential part of the solution today. In order for us to successfully navigate the economic challenges that lie ahead, it will be vital for the financial system to continue operating at full capacity, extending lines of credit to otherwise sound businesses which have been negatively impacted by the temporary shutdown of the global economy. The good news is that due to the stringent regulations put in place following the global financial crisis, banks come into this situation better capitalized than at any point in history, and are well positioned to do their part.